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Investor Confidence and the Market for Good Corporate Governance

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The Backgrounder in Brief

The media have been saturated lately with bad news from capital markets, the recurring theme being a "crisis in investor confidence." Governments and public regulatory bodies have been swift to draft and launch new oversight schemes intended to bolster confidence in corporation financial reporting, while individual firms have taken their own steps to improve their messaging. These reforms could be helpful if they make it easier for investors to distinguish good investment opportunities from bad, and do not impinge on market participants' duty to evaluate projects using their own good sense. Otherwise, reforms will be neutral or worse.

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Recent disappointing returns in equity markets and worse-than-imagined performance in the telecommunications sector — with a barrage of stories of accounting and managerial malfeasance as background — appear to have deeply unsettled investors. Capital markets seem mired in a persistent funk, fuelling popular anger over the worst cases of corporate misbehaviour. This has triggered government action in the United States, including aggressive fraud prosecution, increased penalties for financial transgressions, stricter Securities and Exchange Commission (SEC) controls over corporate financial reporting, and new stock exchange listing rules covering corporate board design and membership. Swift change is also on offer in Canada.

How far should reform be pushed, and in what direction? Government cannot, after all, simply order stock markets to do better. But if investor confidence is indeed at risk, can businesses, regulators, and governments do something to improve capital markets' ability to tell good investment opportunities from bad? This question is central, because distinguishing good from bad is what enables capital to flow readily to potentially profitable projects, generating income for employees and wealth for their savings vehicles and for other investors. If reforms cannot help investors distinguish good and bad, there is no avenue for improving confidence.

The problem is that information — in this case, the message managers wish to send about investment prospects — is costly, and "good" managers need to get a clear and true signal to investors. "Bad" managers have a financial incentive to send false signals about their projects' prospects, and this is precisely why capital markets and regulators have developed such tools as public audits and comprehensive public disclosure of financial statements. The better the disclosure of past results and future prospects, the more able investors are to make judgments about placing their money with current managers.

But the resources used to send signals about quality to potential investors represent effort not spent on the business of doing business. What would be useful, therefore, are mechanisms that increase the relative costs of sending misleading signals. Scope for further government or other regulatory action might exist if it could help good companies improve the relative clarity of their message, making it less costly to distinguish themselves from bad companies. But government regulations that undermined private market signalling could instead make matters worse. Bluntly, rules that increased the cost of doing business without improving the signal would be worse than useless.

The Economics of Stock Market Information

The apparent loss of confidence in stock values is, in part, a problem of information asymmetry, an issue analyzed by several Nobel Prize winners (see, for example, Akerlof 1970; Rothschild and Stiglitz 1976). All investments are risky, and inside investors and managers presumably have an informed view of which projects are likely to succeed or fail, while outside investors cannot distinguish so easily between good and bad projects. This is where earnings histories come into play. A common

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share may be assessed according to its price relative to past earnings — the price-to-earnings ratio (P/E). But the P/E is only indirectly relevant to the worth of a share today. What investors pay for, abstracting from speculative bubbles, is a share of expected future earnings — and a respectable earnings history is routinely taken to be suggestive of respectable future earnings.

Now, managers have an incentive to deliver an optimistic view of past earnings and future prospects, because their compensation typically depends directly or indirectly on the firm's financial performance and its share price. In a number of recent cases, shareholders discovered that reported results (earnings and revenue histories) did not stand up to accounting scrutiny and the passage of time. So even the faint hope that past results could prove indicative of future returns was dashed, given that the results themselves were fraudulent. With this erosion in the value of the earnings signal, outside investors now find it even harder to distinguish firms that are virtuous, with reliable book earnings, from those with questionable accounting practices.[1] In response, they have heavily discounted the reports of most firms, leading to a loss in stock market values for all.

Such information asymmetries have real consequences for the economy. Good firms, with a cost of capital higher than it otherwise would have been, will skip sound economic investment projects. The growth potential of good firms is thus restrained by the behaviour of bad ones.

How the Private Sector Responds

How could individual firms and self-regulators improve investors' confidence?

Investors want to know which ventures are likely to produce positive returns at a fair price, and so do honest managers and promoters, otherwise they will not be reasonably compensated for their own investments of effort and money, and sound projects will go unpursued, harming society at large. Good managers, therefore, will spend resources to demonstrate the credibility of their projects — but so will bad ones. However, if good managers are better able than bad managers to signal their quality, at less cost to themselves or their firms, they will successfully distinguish their firms' merits. Sound firms can distinguish themselves in a number of ways, some of which could be equally classed as potential regulatory choices.

If firms were able to obtain insurance coverage against audit failure and fraud, they would send a signal about their own management quality.

- *Make financial disclosure clearer and more consistent.* Getting the message to investors remains the name of the game, and good managers will be open and expansive about their projects' pros and cons. Historically, clear disclosure and simple, standard reporting have been rewarded with higher stock prices.
- *Purchase financial statement insurance.* If firms were able to obtain insurance coverage against audit failure and fraud, they would thereby send a signal about their own management quality, and insurers would have a suitable and unambiguous incentive to oversee sound audits. As this insurance market developed, publishing the premium rate and terms of coverage would tell

1 One indication of the attention markets have given to this issue is the fact that the number of print media mentions of the phrase "earnings quality" doubled between the first and second halves of the past decade.

investors even more about firms' financial management and reporting quality (see Ronen 2002).

- *Disclose management compensation terms in a clear and timely manner.* Although employee compensation terms are best negotiated between management and shareholders, the latter need to know what is on offer and to have a reasonable opportunity to approve or reject management proposals. Thus, for example, a sound governance program might require direct shareholder votes on incentive plans for corporate officers. If the firm's owners are satisfied that their interests are effectively represented via board elections, they may choose to let the relevant decisions rest with the board's compensation committee.

Employee compensation terms are best negotiated between management and shareholders.

- *Encourage inside investors to buy more stock in their firm.* Investment by insiders can help signal their confidence in a firm. Managers will be reluctant to invest in a firm's shares if they privately have dim expectations about its prospects (see Leland and Pyle 1977).
- *Include more independent directors on corporate boards.* The placing of more outside or independent directors on boards and in key roles, such as chairing audit, compensation, and governance committees, is a growing trend among public firms and will be a listing requirement for several major stock exchanges. There is a risk that decisions will be made by board committees that are less informed than otherwise about a firm's operations, but that cost is likely to be small relative to the expected benefit of having strong shareholder representation for key decisions over the life of a firm.
- *Pay cash dividends to investors or repurchase shares.* Cash-constrained companies find it harder to pay out dividends, so good firms can use dividend payments to signal their quality (see Miller and Rock 1985). This signal is not, however, static free, because it could indicate that the firm's management has few ideas for profitable projects to pursue; furthermore, share repurchase can be used to "manage" earnings-per-share results, and has been criticized for that reason as well.

With investors concerned about widespread fraud in the marketplace, good managers will choose these and other mechanisms to signal their firm's quality. At the same time, however, the need to improve the signal is itself a wasteful diversion of scarce resources — that is the real cost of the mismanagement of firms such as Enron and WorldCom.

The Regulatory Response

The economics of information suggest criteria that could be used to choose regulatory actions intended to improve market confidence. The key criterion is that regulation should make it harder for bad firms to imitate good firms by mimicking their market signals.[2] If regulation makes it easier for poor firms to imitate good firms, making market signals less reliable, then investor confidence may be undermined rather than improved.

It is in this light that one should ponder the SEC's recent declaration that chief executive and financial officers must certify the accuracy of numerous filings with

2 See Mintz (1997). Policies that make it more difficult for poor-quality firms to imitate good-quality firms can improve the performance of markets.

It is impossible, of course, for a chief executive to verify every line of a securities filing.

the agency.[3] It is impossible, of course, for a chief executive to verify every line of a securities filing or plausibly testify to the accuracy of every figure that underlies that filing — that is the work of a staff of full-time auditors, perhaps numbering in the hundreds and spread around the world. With its new rules, however, the SEC seeks to impose a common standard with a responsible human face, expressing a pledge of character, if little else, behind each public filing. In addition, the SEC rule exposes corporate officers, in the event they are believed to have offered intentional misrepresentations, to the possibility of a relatively speedy appearance before federal authorities.[4]

The obvious aim of the new SEC rules is to provide a recognized forum for testimony to the honesty of managers and to strengthen the legal penalty that attaches to dishonesty. By increasing the penalties for the release of dishonest statements, the SEC hopes to make it easier for investors to discern good projects from bad and, arguably, at much less cost to good managers.

Beyond these facilitative measures, however, there is room for serious doubt about the potential effectiveness of more government control over corporate governance and behaviour. Some recent suggestions, such as requiring the rotation of auditors on a fixed cycle, might actually weaken markets. Because the choice of auditor is itself a signal of quality, in the sense that firms attach dignity to their financial statements by selecting a reputable auditor, the imposition of rules that further narrowed firms' choice of auditor would remove that choice as a signal about the quality of financial reporting. Investors would be less able to judge whether a good firm had engaged better auditing than had other firms.

Governments and regulators could take other actions, but most of them offer little improvement in the quality signal. Some examples follow.

- *Impose stiffer regulatory or legal penalties for fraudulent or materially misleading securities filings.* Directly raising the cost of being caught cheating[5] is a straightforward way of encouraging trust in firms' financial reports.
- *Introduce government oversight of auditors' conduct.* This and similar interventions are intended to reinforce public confidence in the audit function, but run the risk of misaligning interests and incentives. Thus while the United States has already announced the creation of a "Public Accountability Board" that would oversee accounting standards and implementation, there is no particular reason to assume such a board would improve investors' ability to select sound projects. In Canada, the federal government has also created the "Canadian Public Accountability Board," a public oversight body with some private professional input that will monitor and enforce accounting practice. The potential impact on the quality of information available to investors is at best unclear. We should be wary of the perception of implicit government certification of results, because

3 The SEC has published a list of the 947 largest public firms traded in the United States to which the new rules apply.

4 Fraud was, of course, already a criminal issue, but under prior US federal law, publishing misleading financial reports was an offence that had to be pursued within the scope of mail fraud.

5 Implicitly holding constant the likelihood of being caught. The SEC is also expanding its investigative and enforcement capacity; Ontario has already done so.

that would risk investors' feeling free of the burden of inspecting financial reports and making decisions based on their judgment of a firm's prospects.

- *Demand ever more fine-grained reporting standards.* A company that files reports matching the finest details of generally accepted accounting principles (GAAP) nonetheless may be presenting a misleading picture of its past and prospects. While transparency and consistency are good, the world is a complex place, and ever more prescriptive GAAP rules cannot substitute for sound judgment calls in financial reports. We should be wary of a GAAP specification that created safe harbours for financial officers and their auditors who fulfill the form but not the function of the audit mandate. Regulatory focus on the standard itself may distract attention from the business of ensuring that audit reports present a fair assessment of a firm's financial condition; attention to a fair and reasonable assessment may produce better outcomes than an even more prescriptive GAAP standard.

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- *Legislate restrictions on compensation design.* It is often asserted that incentive-based compensation puts excessive pressure on managers to overstate past and potential earnings. Compensation is, however, clearly a matter for shareholders and managers to resolve within the firm. Compensation packages can be arranged in many ways, while delivering correctly aligned incentives for managers; the single important constraint is that they be acceptable to shareholders.
- *Require that employee stock option grants be expensed immediately.* Most public firms do not record an expense when a stock option is granted to employees, on the grounds that the firm incurs no cash cost through what is, in essence, a transaction between owners having no direct bearing on earnings. The argument against such a practice is that not recording an expense allows firms to exaggerate earnings available to shareholders, creating an undue incentive to award options rather than other forms of pay; moreover, option incentives themselves encourage managers to behave too riskily. Yet simply expensing options, even assuming that firms adopt a consistent methodology for doing so, may create a bottom line that misrepresents their current financial positions, while providing shareholders with no information beyond that already included in the accounting entry showing net income per fully diluted share. When the latter accounting concept is already available to shareholders, the expensing of options may make accounting statements murkier, not clearer. Reporting diluted earnings — reflecting the public share float after allowing for the potential exercise of stock options and other convertible instruments — provides investors with sound information about their potential share of earnings.
- *Forbid company loans to corporate officers.* Complaints are occasionally made that some senior officers treat the corporate treasury as a private bank. This is a legitimate concern, but one over which shareholders normally should have complete control. Company loans can have a legitimate purpose in an incentive-based compensation program, particularly when they are made available to purchase company stock. Owning stock, rather than options, quite effectively aligns employee incentives with those of other shareholders; permitting loans with reasonable terms makes it possible for individuals to take a stake in their firm's success (or failure) without imposing undue financial hardship.

In general, governments lack information about what managerial arrangements and behaviours are likely to be most effective. Moreover, compared with firms themselves and the self-regulating organizations they sponsor (such as broker/dealer associations), governments do not have the same incentives to get the answers right. The information barrier causes external regulators to be uncertain both about the benefits and costs of different governance arrangements and about the costs to firms of imposing rules for particular managerial or financial reporting choices. And neither governments nor external regulators bear the immediate costs of getting those choices wrong.

Self-regulating organizations, because they depend on the existence of a healthy industry to regulate, have a powerful incentive to find mechanisms that are neither so lax as to undermine investor confidence nor so strict that firms find business unprofitable. When investors' capital is readily mobile and when there is uncertainty about firms' costs of compliance, self-regulatory organizations are likely to deliver better results to society than can government rulemakers (Scarpa 1997).

Meanwhile, investors can and do react quickly to poor market performance, bad managerial decisions, or malfeasance. Shareholders swiftly reallocate their portfolios when firms go bad, and impose a harsh market discipline on firms that exude the faintest whiff of internal rot. Thus, for example, the rapid decline in the value of WorldCom stock since summer 2000 tracked market assessments of most telecoms' prospects, which had been dimming; questions about the firm's accounting accompanied the price slide, but an SEC investigation was announced only when the firm's market value had all but disappeared. There is, however, a persistent public cost associated with malfeasance, including the higher premium that must be paid to attract nervous investors, and avoiding this cost is the plausible justification for public-confidence-building policy action.

Concluding Comments

Financial markets produce a steady flood of information, and investor confidence depends on detecting an accurate signal about currents within the flood. Governments and regulators seeking to bolster confidence need to be cautious about reducing incentives for investors to monitor market signals — but there may be scope for making true signals easier to detect than false ones. This means that governments and their agencies should set new rules if they can identify a specific market failure and its appropriate remedy, and if that remedy would indeed improve market function.

Governments and their agencies should set new rules if they can identify a specific market failure and its appropriate remedy.

Legislative and regulatory changes should be contemplated only where the cause of a problem is clearly understood,[6] and so is the channel by which rule changes are expected to achieve the desired results. Given the difficulties that information costs pose and the fact that market decisions are always made under uncertainty, it is hard to see how this hurdle will often be cleared. Commentators who clamour for government action must be prepared for the possibility that rule changes restricting managerial decisionmaking may make financial and social outcomes worse, not better.

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6 One might reasonably wonder whether the generic loss of investor confidence fits in this category.

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